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Quants Feast in the Land of Retail Investors

Acadian Asset Management, one of the few U.S. firms approved to play in China's stock domestic market, aims to capitalize on irrationality.

By Julie Segal

After China eliminated the two-term limit that paved the way for Xi Jinping to be president for life earlier this year, companies with the word "emperor" in their names rallied.

That market irrationality isn't dampening Acadian Asset Management's enthusiasm for the country's relatively new A-share market. In fact, the quantitative asset manager, which oversees $103 billion, is bullish about A-shares in part because of the behavioral mistakes it believes local Chinese investors make in trading on news headlines and other short-term information.

Speaking at a lunch earlier this week in New York, Asha Mehta, senior vice president and a portfolio manager on Acadian's emerging markets team, said retail investors add valuable liquidity, which lowers the the cost of buying and selling, and information about the market. Retail-driven volatility also provides the firm abundant opportunity to buy stocks at attractive prices. Retail investors represent 80 to 85 percent of total trading volume in A-shares, according to Mehta.

The Chinese government recently started allowing foreign investors to invest in China's domestic market via A-shares — the second largest equity market in the world. Acadian is one of a handful of U.S. firms that have gotten the green light so far from the Chinese government. The company launched an A-shares strategy, seeded with internal funds, earlier this month.

Mehta said that retail investors dominate the markets for a number of reasons, including a liberalization of capital controls. Investors are now looking to put to work an estimated $30 to $35 trillion that they have sitting in bank accounts. There are 90 million Chinese retail accounts in the country, Mehta noted, and 30 to 40 million of those are registered for market-focused chat rooms on popular app WeChat.

Mehta conceded that retail investors' behavior is itself a risk, but mitigated by building diverse portfolios. It's not the only risk. The political environment, corruption, and the government's control of the market also can rock any investments in the country. But the Acadian manager sees China as attractive by many measures and predicts its share of global benchmarks will only grow over time. In her view, most institutional investors as a result are significantly under-allocated.

Active managers, particularly quants, are drawn to the market because it has a diverse range of companies across sectors and industries, and plentiful data on them, including pricing, volume, and financial statement information. Acadian follows all 3,500 companies in the market and then builds portfolios of 100 to 200 stocks. Fundamental emerging markets managers are developing far more concentrated books.

China's equities are performing as managers expected. Data show, for instance, that stocks in companies with strong balance sheets, attractive valuations, and other quality characteristics typically go on to perform well, and that the opposite is true, too. This allows quant models to pick likely winners over a year-long horizon or even shorter time frames, such as one month. "Despite the retail nature of the market where you can get irrational themes driving daily pricing, we can get attractive returns by investing in fundamentals in a systematic way," Mehta said.